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E.O. 12958: DECL: 12/22/2034
TAGS: ECON EFIN ETRD EINV PREL PGOV CH
SUBJECT: CHINA REBALANCING: HOW MUCH, HOW SOON, AND HOW?

REF: A. BEIJING 03307
¶B. BEIJING 03122
¶C. BEIJING 03191
¶D. HONG KONG 02178

Classified By: Economic Minister Counselor William Weinstein; Reasons 1.4 (b, d)

¶1. (C) Summary. Recent senior leadership meetings in Beijing indicate that with 2009 GDP growth in excess of eight percent assured, the Chinese Government has turned its attention to rebalancing the economy for more sustainable development. Most observers believe the government is serious about the need to rebalance, and is making substantive efforts in many areas, although much more understanding, funding and action are needed. For 2010, while the "proactive fiscal" and "appropriately accommodative monetary" policies of the past year will continue, both "managing inflation expectation" and "adjusting economic structure" have been grafted onto the overall GDP growth target. Various economists forecast actual growth to reach 8.5-9.5 percent, but with a different composition. Public expenditure on social security, education, health care, low-income housing, agriculture, and environmental protection will increase, certain new or strategic industries will be targeted for support, and funding for infrastructure investment projects already underway will continue. On the monetary side, the government has begun to tighten, but not so sharply as to risk a too-early exit. One significant addition to economic policy is promotion of urbanization to small and medium cities through relaxation of the household registration system, which should contribute significantly to household consumption and economic rebalancing.

¶2. (C) Summary, continued. Beyond the need for rebalancing, key concerns for China's economic policy-makers in the coming year include inflation, which for now remains very low, and possible negative consequences of 2009's enormous flood of new bank credit, including misallocation of credit, non-performing loans (NPLs), asset price bubbles, and massive local government debt. As much as twenty percent of 2009 lending might eventually become non-performing, but probably not until overall economic growth slows in 2011-15. China's financial regulators are aware of the problems and adopting appropriate preventive measures, but certain aspects of the problem are beyond their control, including continued promotion of investment-led economic growth by powerful ministries and local governments. Other economic issues not yet addressed include asset price bubbles, price reforms, exchange rates, and other financial sector reform needs. China also needs to reform intergovernmental fiscal relations, including the system for transfers from relatively

wealthy provinces to poorer areas, as well as the structure of tax revenue, but the current leadership apparently has no interest in doing so. End Summary.

Comment

¶3. (C) China's leadership understands the need for greater economic rebalancing to promote sustainable growth and development, although they have not reached consensus on how and how rapidly to implement policy reforms to meet this need. Issues of more direct relevance to the United States and other trading partners, such as exchange rates and trade balances, are closely linked to rebalancing and will be impacted by policy adjustments. The internal debate on when and how to withdraw fiscal and monetary stimulus measures will continue, with various central and provincial jurisdictions holding divergent views and agendas. In Beijing, the pro-GDP growth through investment factions will continue to cite social stability concerns and weak overseas recoveries to justify continuation of the stimulus, while financial regulators will continue to raise concerns about misallocation of investment, asset bubbles, and future non-performing loan problems. Beyond Beijing's ring roads, however, provincial and local officials will continue to promote infrastructure and industrial investment projects that enhance their local economic statistics and personal career prospects, unless and until they receive strong and clear instruction from Beijing to do otherwise. End Comment.

China's Successful 2009

¶4. (C) The Chinese Government took a two-stage approach to

economic management during the global crisis, according to National Development and Reform Commission (NDRC) Academy of Macro-economic Research Vice President Wang Yiming (ref a): first arrest the downturn, then resume the rebalancing that began before the crisis. The most recent batch of macroeconomic indicators, released in early December, indicate the first goal has been met: 2009 GDP growth easily should surpass the eight percent target, with some economists predicting the year-end figure will reach 8.4-8.6 percent. In a recovery strongly underpinned by effective fiscal and monetary stimulus programs, China's GDP growth has accelerated through the first three quarters of 2009, primarily due to government-related fixed asset investment and to a lesser extent consumption. While net exports remain negative due to still-weak external demand, exports have begun to improve and imports have surged from last year's low level. Inflation has remained negative for most of this year.

¶5. (C) Despite this impressive performance, however, some senior officials continue to believe China's economic recovery remains fragile. China Securities Regulatory Commission (CSRC) Vice Chairman Yao Gang, for example, told a visiting Federal Reserve delegation in mid-November that until private consumption, rather than government investment and bank loans, becomes a primary driver of the economy, it would be premature for the government to terminate its stimulus measures (ref a). Other contacts worried that external demand would remain weak until key overseas markets fully recover, which they did not expect for another 2-3 years. For those reasons, IMF Senior Resident Representative Vivek Arora said China would maintain fiscal stimulus programs through 2010, while gradually unwinding monetary measures.

Time to Calm Down and Rebalance

¶6. (C) The above concerns notwithstanding, as steady improvements in most indicators have continued to accumulate, and with the worst of the global crisis apparently over, officials increasingly have turned their attention to sustainable growth over the longer term, which includes rebalancing. In the words of World Bank Senior Economist

Louis Kuijs, "the government now can calm down." He said during the global crisis, China's "quest for growth" -- which other contacts characterized as "panic" -- had over-ruled structural reforms, which he now hoped would resume. The "bright side" is that the government now is serious about the need to rebalance and is making substantive efforts to increase its presence in health care, education, and other needed sectors. Dragonomics Managing Director Arthur Kroeber believed the government already has "made a good start," with significant improvements underway in education, health care, and pensions, although much more funding is needed.
¶7. (C) IMF Resident Representative Tarhan Feyzioglu agreed with this assessment, opining that the key government agencies all understand China's need to increase consumption and rebalance the economy; the problem is they do not know how to do it. In particular, the NDRC -- which coordinates economic policy recommendations to the State Council -- retains a "command economy reflex" rather than employing market mechanisms to redirect growth. Also, while Feyzioglu welcomed the new emphasis on service sector growth, he cautioned that the "big money" continued to flow to large industrial projects.

Internal Debate: When and How to Rebalance?

¶8. (C) The shift of economic policy focus has been under discussion for some months: in late September, NDRC Director General Xu Lin told visiting U.S. Treasury officials there already was consensus that 2009 GDP growth would exceed eight percent, so debate had shifted to how to sustain growth over the next few years without strong external demand. He said the NDRC favored extension of fiscal stimulus policies through 2011 or even 2012, although he thought the more fiscally conservative Ministry of Finance (MOF) and some other agencies might disagree. Xu, observing that the NDRC "always has these issues with MOF," said the State Council would need to determine policy.

¶9. (C) After several months, that determination appears to be a compromise: the stimulus is to continue, but with more attention to rebalancing and to prevention or mitigation of negative consequences. In mid-November, Vice Minister Liu He

of the Central Leading Group for Finance and Economics acknowledged China's need to rebalance toward greater household consumption, and said both consumption and urbanization would play greater roles in the 2010 policy framework (ref b). Other policies, including education, social safety net, low-income housing, and infrastructure would flow from these rebalancing themes. The November 27 Politburo meeting confirmed these changes, which then were discussed and disseminated at the annual Central Economic Work Conference (CEWC) in early December (ref c). A December 9 State Council meeting provided more substance, including extension and expansion of some consumption stimulus measures.

2010: Continuity, with Adjustments

¶10. (C) China intends to maintain the broad direction of economic policy for the coming year. The "proactive fiscal" and "appropriately accommodative" monetary policies of the past year will continue, but with greater attention to the quality of growth. "Managing inflation expectation" and "adjusting economic structure" have been grafted onto the overall GDP growth target. Various Chinese and foreign economists now forecast 2010 GDP growth to accelerate slightly to 8.5-9.5 percent, but with a different composition. Kuijs of the World Bank said China's domestic economy has enough momentum to fuel strong domestic demand growth, even with much less expansionary support from government-influenced spending. Officials also hope modest recovery in overseas markets will bring single-digit growth to net exports. At the same time, continuing growth in property investment and construction, together with some acceleration of household consumption growth, should enable

the economy to meet the overall GDP growth target.

¶11. (C) For fiscal policy, public expenditure on social security, education, health care, low-income housing, agriculture, and environmental protection will increase. UBS economist Wang Tao told us the government also intends to use industrial policy to facilitate restructuring toward designated new or strategic industries, as Japan and South Korea have done in the past. Funding for infrastructure investment projects already underway will continue, but any new proposals will receive closer scrutiny. On the monetary side, the IMF's Feyzioglu said the government needed -- and has begun -- to start tightening monetary policy, but not so sharply as to risk a too-early exit. In 2009, China wanted to "push money out quickly," but that is no longer the case. Wang Tao of UBS said the government has not set a formal lending quota for 2010, but instead has given the banks a "target" of 17-18 percent credit growth, which would mean RMB 7-7.5 trillion new lending. Also, more credit support may be directed to small and medium enterprises and sectors with greater job creation potential.

New Focus on Urbanization

¶12. (C) Both Chinese and foreign economists characterized the CEWC's decision to promote urbanization as an important and encouraging policy change that will contribute significantly to expansion of household consumption, thereby promoting economic rebalancing. More specifically, the CEWC announced relaxation of the household registration system, which for decades has impeded labor mobility, to allow rural residents and their families to move permanently to medium and small cities. The new policy should boost private demand for lower-cost urban housing, while improved access to social services for the migrants also may reduce precautionary saving and increase consumption. CICC economist Ha Jiming estimates the policy change will allow approximately 25 million additional rural residents to move to the cities over the next five years.

¶13. (C) These new urbanites should boost China's real estate and construction sectors, which already in recent months have been major factors in economic growth. November's monthly property sales and construction figures set new records, as low interest rates, low taxation, discounted mortgage rates, and abundant liquidity in the market all encouraged buyers. According to China Construction Bank Vice President Hwa Erh-cheng, investors seeking a hedge against future inflation also have become "a force in the market," and he expects overly exuberant housing price expectations to generate future bubbles. With more lower-income buyers, Kuijs also noted that further "rebalancing" within the real estate

sector -- from construction of luxury developments toward more affordable housing -- will be needed.

Key Concern Number 1: Inflation

¶14. (C) Inflation remains a worry for Chinese leaders, as they believe significant consumer price rises could spark social instability among low and fixed-income groups. After recording negative inflation rates for the past nine months before turning slightly positive in November, however, most economists do not see significant inflation as a short-term problem. The IMF's Feyzioglu said he was not concerned about any imminent inflation resurgence, as recent food price rises were "normal," but asset prices remain an area to monitor. He believed the government would watch price data closely and act quickly if inflationary pressures appear to build. Dragonomics Managing Director Arthur Kroeber was more concerned, expecting inflationary pressures by mid-2010 to become greater than the government could tolerate, especially in the real estate sector.

Key Concerns Number 2: Credit Boomerang

¶15. (C) China's year-long, unprecedented bank lending flood (RMB 9.2 trillion from January through November, 122 percent higher than the same period of 2008) apparently has ended, as monthly credit figures have returned to near-normal levels. According to Kuijs of the World Bank, the lending spree may have produced or sown seeds for several future problems, including misallocation of credit, a possible large increase in non-performing loans (NPLs), and asset price bubbles. One particular, relatively unnoticed concern is massive local government debt, incurred as city, county, and district jurisdictions established local investment platforms to raise the matching funds needed for central government financing of stimulus projects.

¶16. (C) Regarding NPLs, Wang Tao of UBS estimated that up to thirty percent of stimulus-related lending was directed to local governments for infrastructure projects with no real expectation of repayment. Overall, she thought about twenty percent of 2009 bank lending eventually would "go bad," probably when overall economic growth slows in 2011-15. The IMF's Arora believes NPLs could rise significantly as early as 2011-12, although he also thinks the government has the fiscal capacity to intervene if needed. Feyzioglu said the China Banking Regulatory Commission (CBRC) would need to maintain strong macro control over the banks, which thus far it has done, although internal bank governance remained a fundamental problem. He said China's large commercial banks, which received the "best part" (centrally-led investment projects) of the stimulus, generally had sound capital structures, but some of the smaller city commercial banks that were closely linked to local governments were worrisome; there is a dangerous "triangle" at local levels that includes enterprises, government, and bank branches, from which the banks should be extricated.

¶17. (C) UBS economist Wang told us the People's Bank of China (PBOC), the financial regulators (CBRC and CSRC), and possibly MOF understand these current and future risks, and are attempting to prevent and mitigate problems stemming from the lending binge. In early December, for example, the CBRC raised required capital adequacy ratios (CAR) to eleven percent for large commercial banks and ten percent for medium and small banks. More recently, on December 9 the State Council approved a CBRC proposal instructing commercial banks to assess and prevent six types of lending risks; the agency is requiring the banks to perform these risk assessments retroactively on loans issued since November 2008. Wang said these financial conservatives are to some degree opposed, however, by the powerful pro-GDP growth camp, which includes the economic ministries and provincial and local governments, the leaders of which are evaluated and promoted in part on their ability to deliver economic growth and tax revenue. (Note: A December 6 report by the Bank for International Settlements in Basel, Switzerland warned that China's rapid credit expansion of the past year had increased risks to the banking sector. The report specifically noted that any future tightening of lending policies might leave some projects short of funds before they are completed. End note.)

Key Concerns Not Addressed

¶18. (C) Published reports of the recent Politburo, CEWC, and State Council meetings largely omitted detailed discussion of monetary policies, asset price bubbles, or price reforms, including utility prices, interest rates, and exchange rates. As noted above, continuing abundant liquidity raises the possibility of asset bubbles, but the central bank and financial regulators will want to avoid the need for a sharp tightening of credit. The IMF's Feyzioglu said whether or not bubbles form in the equity and/or property markets next year will depend on policy measures; one way to avoid them would be for banks to raise deposit rates, but "that's not

going to happen." Inflation was mentioned in the reports, but generally only in the context of "managing inflation expectations." These issues undoubtedly figured prominently in preparations for the policy meetings, and will be closely monitored in the coming year; as conditions warrant, officials will be prepared to adjust policies.

¶19. (C) Both the IMF (Feyzioglu) and the World Bank (Kuijs) emphasized China's need to deepen reform in the capital, bond, and equity markets; liberalize interest rates; and relax exchange rate controls. For various reasons, the government is reluctant to address these issues at this time; on interest rates, for example, officials worry that elimination of the deposit rate ceiling would provoke "excess competition." Regarding exchange rates, with export recovery still weak, most analysts expect the RMB-USD exchange rate to be held steady until mid-2010, when gradual appreciation might resume.

¶20. (C) Several contacts noted a strong need for China to reform intergovernmental fiscal relations, including the system for transfers from relatively wealthy provinces to poorer areas. Kroeber of Dragonomics said the current leadership, however, has no interest in pursuing this topic, or in significant financial sector reform, preferring to "kick the problems down the road" to its successors in 2012. He said many Chinese economists believe fiscal reform is more important and urgent than financial reform. Those economists emphasize the need to alter the structure of revenue at the local level, which now is based on value-added tax and land sales.
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